PENSION COMMISSION OF ONTARIO

Policy Recommendations for the Regulation of Pension Fund Investments

PART A

1) INTRODUCTION

The current Ontario Pension Benefits Investment legislation existed, with the exception of minor housekeeping adjustments, unchanged from 1965 to 1982. At that time regulations regarding pooled real estate funds were added. In 1984 regulations dealing with investments in resource properties and credit insurance were passed.

The current legislation relies heavily on specific quantity and quality tests, prohibitions and on certain exceptions. It is also "piggy-backed" on the Canadian and British Insurance Companies Act and the Loan and Trust Companies Act.

Although the Federal Government and other provincial regulations used the same approach in regulating pension fund investments, there has been an increasing lack of uniformity in the application of investment standards across the country.

The need to balance the overall portfolio, hedge certain risks and to provide appropriate returns have put pressure on the investment community to develop new forms of investments and new investment strategies.

The adoption of the prudent person approach in the United States with its move away from the traditional quantity and quality tests and restrictions have brought pressure to bear on the Commission to give consideration to the adoption of a similar approach in Ontario.

These factors along with suggestions from investment fund managers and the investment community have caused the Pension Commission of Ontario to review its existing legislation respecting pension fund investments.

At its meeting of 7 February 1985, the members of the Pension Commission, acknowledging the urgency of an official Ontario position in pension plan investment matters, established an investment subcommittee and directed the subcommittee to meet in order to carry out the Commission's directives.

The Commission directed the Subcommittee to:

- review and assess the changes needed to the investment regulations of the Pension Benefits Act;
- review and assess the opinions, suggestions, requirements and proposed legislation of other jurisdictions;
- address uniformity of investment legislation;
- study and make recommendation with respect to the prudent person approach to investments;
- meet with representatives of the public, industry and other outside agents;
- report back to the members of the Commission with its recommendations.

The Subcommittee held meetings with

- federal and provincial pension regulators,
- investment counsellors, securities lawyers and representatives of

  trust companies,

  the Canadian Life and Health Association,

  the Toronto Futures Exchange,

  The Canadian Labour Congress,

  The Canadian Depository Service.

Concurrently, various jurisdictions, most notably those of Ontario, Quebec and the federal government, conducted surveys and studies on the current needs and requirements of the loan and trust industry, the insurance industry and the pension investment community.

Although there have been discussions among the regulatory bodies there are differences in their positions. Within our study we have focused most notably on the Federal and Quebec positions.

PART B

PENSION COMMISSION OF ONTARIO

Recommendation on the Regulation of Pension Fund Investments

Proposed Legislation

The Pension Commission of Ontario proposes to adopt the "prudent person approach" for the investment of pension fund assets subject to the Ontario Pension Benefits Act.

Although the proposed Pension Benefits Act, 1986, does not address the matter of investments in detail, it does contain certain references to "prudence" and "reasonableness", in other areas such as:

a) the prudent and reasonable supervision by administrators of appointed persons or agents, whatever the function of the latter group may be.

b) a general prohibition against conflicts of interest.

c) a requirement for administrators to exercise the degree of care, diligence and skill that a person of ordinary prudence would exercise in administering a fund.

d) a requirement that administrators with relevant knowledge or skills employ these in administering a fund.

The Commission also recognizes that if the prudent person approach were adopted without any other constraints, a strong regulatory body would be required to monitor the investment of pension fund assets.

However, it is the preference of the Commission to have a system that works well and safely while keeping monitoring to a minimum.

Since the Commission is unaware of any self-regulatory bodies in the investment community it therefore must recommend the adoption of the prudent person approach with some restrictions in certain specified areas. In addition to these restrictions the requirement for disclosure of certain information concerning investments to the members of pension plans, audits of the pension fund and an expansion of the Commission's power should permit the operation of the fund with a minimum of supervision.

It is felt that these requirements will:

- allow fund managers greater freedom and flexibility in making investment decisions;
- eliminate quality tests and the "basket" clauses;
- ensure diversity by retaining quantity tests;
- impose penalties for imprudence;
- ensure that there are strict rules governing conflict-of-interest and self-dealing;
- ensure pension fund investment is limited to that of a passive investment risk;
- require annual audits of certain funds;
- require disclosure of certain investment and financial information to the members of a pension plan and to the Advisory Committee;
- permit the Superintendent to institute legal action for imprudent investment;
- require the establishment of written investment goals and objectives.

PART C

MAIN PRINCIPLES AND RECOMMENDATIONS

(1) PRUDENT PERSON APPROACH

Pension fund investment has become increasingly sophisticated and it is desirable that fund managers be able to participate in these investments to hedge risks and balance the portfolio.

Recommendations:

a) The Pension Commission of Ontario adopt the prudent person approach for investments made by pension plans registered in Ontario;

b) The prudent person approach be defined as the exercise of care, diligence and skill in the administration of the fund that a person of ordinary prudence shall exercise in dealing with the property of another person using all relevant knowledge and skill that a person by reason of his or her profession, business or calling ought to possess.

(2) WRITTEN OBJECTIVES AND GOALS

A prudent investment policy must be developed for each plan and be stated as a part of the plan documents. Fund Managers and Plan members should have knowledge of the policy.

Recommendations:

a) The sponsor or administrator of the plan will be charged with the responsibility for establishing the

investment policy for the plan. This policy shall contain specific criteria related to asset mix, investment quality and quantity tests. The policy shall be contained in the pension plan or the investment contract.

b) The establishment of this investment policy will not be required under a fully-insured pension plan.

c) Anyone assuming the responsibilities for administering the pension fund would be required to accept the criteria established under the plan.

(3) QUALITY TESTS AND THE BASKET CLAUSES

The current tests and basket clauses have been described as artificial and limiting factors in overall portfolio quality and have been criticized as preventing plans from investing according to the best interests of plan members.

However, despite the implicit onus of prudence embodied in the current law, some pension fund managers have relied upon the quality tests and the basket clauses believing that the courts would be reluctant to find a sponsor who conforms to the current tests to have violated the duty of prudence.

Recommendations:

The current quality tests and the basket clauses be eliminated from the Regulations.

(4) DIVERSIFICATION

There is a need to prescribe diversification to prevent a plan sponsor from putting the entire pension fund at risk by concentrating for example on one investment. The following recommendations have been prepared using the current reference to book value of assets. The Pension Commission invites submissions whether the market or actuarial value of assets should be used instead.

Recommendations:

a) The amount that could be invested in the securities of or loans to any business entity be limited to 10% of the total book value of pension plan assets;

b) In the case of a group of related non-publicly traded businesses, that are affiliates as defined under the Ontario Business Corporations Act 1982, the 10% limit shall apply to the entire group;

c) Direct investment in real estate and resource properties be limited as follows:

   i) a maximum of 5% of total book value of plan assets in any one parcel of real estate or resource property;

   ii) a maximum of 15% of total book value of plan assets in resource properties;

   iii) a maximum aggregate amount of 25% of total book value of plan assets in real estate and resource properties.

d) The 10% limit in a) above not apply to pooled, segregated and mutual funds or to certain corporations whose investments are limited to those which a pension plan may make providing the respective pooled, segregated and mutual funds or certain corporations follow the recommendations set out herein.

e) The 10% limit in a) above not apply to issues that are guaranteed by the Government of Canada or a province of Canada.

(5) CONFLICT OF INTEREST

It was generally agreed that potential or actual conflicts of interest and self-dealing are imprudent and should be strictly regulated or in some instances prohibited entirely.

Recommendations:

a) Investments in and/or loans to the plan sponsor be prohibited subject to certain exemptions that may be approved by the Commission.

b) In the case of a group of related, non-publicly traded businesses, that are affiliates as defined under the Ontario Business Corporations Act 1982, the prohibition shall apply to the whole group;

c) Trading of investments between the plan and the plan sponsor be prohibited;

d) Investments by the plan in real estate occupied by or to be developed by the plan sponsor be prohibited;

e) A plan sponsor be permitted to charge the plan assets for ancillary service performed externally, to a reasonable amount; and

f) A plan sponsor be prohibited from charging the plan assets for ancillary services performed internally by its employees.

(6) CONTROL OF PRIVATE SECTOR COMPANIES

It was generally agreed that a pension plan should be a passive investor and not exert significant influence over private sector companies.

Recommendations:

a) Pension funds be required to restrict the risk with respect to investments of the funds to that of a passive investment risk, and they be prohibited from being in a position to exercise significant influence over the operating and financial position of an investee even though they may not legally control the investee;

b) It be presumed that, where a fund holds less than 10% of the voting interest in an investee, the fund does not have the ability to exercise significant influence;

It be presumed that the holding of 10% or more of the voting interest in an investee results in the ability to exercise significant influence unless there is substantial evidence to the contrary;

Substantial or majority ownership by another investor need not necessarily preclude a fund from exercising significant influence;

c) A fund manager be prohibited, unless given specific voting instructions by the plan sponsor, from voting the shares of managed funds;

d) Recommendation c) above be extended to trust companies and insurance companies in their fund management capacities;

e) A fund manager, managing a group of funds which in the aggregate hold more than 10% of the voting rights of an investee, be required to request that the fund trustee or plan sponsor vote the securities so that the manager is precluded from putting himself in a position of exercising significant influence.

(7) OTHER CONSIDERATIONS

Other areas of consideration included securities lending, pension fund borrowing and the holding of assets in a nominee name.

Recommendations:

a) Managers be permitted to loan pension fund investments if the loans are secured by cash or highly liquid securities (Government of Canada Bills) to the extent 110% of the loan;

b) Pension fund borrowing continue to be restricted to short term to avoid a distress sale of assets and that the fund assets not be used as collateral; and

c) All pension plan loans and investments be held in the name of the pension plan.

(8) AUDIT AND DISCLOSURE

All plans are not at present required to be audited nor does current legislation provide the members with access to certain financial and investment information.

Recommendations:

a) An annual audit by a public accountant be required for pension funds with 50 or more members.

b) The audit shall conform to generally accepted auditing standards as contained in the Canadian Institute of Chartered Accountants Handbook.

c) Members of such plans have access to the audited financial statements of their plan's pension fund; and

d) Certain summary information on the fund portfolio be made available to the members.

(9) SUPERVISION BY THE PENSION COMMISSION

In order for the Pension Commission to monitor and ensure that the general principle of prudence is adhered to and that the pension fund's solvency is not impaired, the Commission's current powers need to be broadened.

Recommendations:

a) Appropriate penalties for non-compliance in investment matters be developed;

b) The Superintendent be empowered to take legal or other warranted action in situations where the Commission is of the view that the fund may not have been managed prudently;

c) The Superintendent be empowered to order an administrator to divest the pension fund of a given investment or desist from an action or policy if the Commission has reason to believe that such investment, action or policy is undermining the solvency of the pension fund;

d) The Superintendent have the power to exclude from a fund's asset valuation any investment whose value could not be readily determined;

e) The Superintendent be empowered to call for an independent valuation of any investment where no clear market value exists; and

f) The Superintendent be empowered to charge the cost of such independent valuation to the plan sponsor.